

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Havice, et. al. Analyst: John J. Pavalasky Bill Number: AB 1120

Related Bills: \_\_\_\_\_ Telephone: 845-4335 Amended Date: 6/15/99

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Eliminates sunset/Exclusion/50% of Gain From Sale Of Qualified Small Business Stock Held For More Than 5 Years

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended \_\_\_\_\_.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED \_\_\_\_\_ STILL APPLIES.

☒ OTHER - See comments below.

### SUMMARY OF BILL

Under the Personal Income Tax Law, this bill would remove the January 1, 1999, sunset date on the issuance of qualified small business stock, thereby making the exclusion permanent.

### SUMMARY OF AMENDMENT

The June 15, 1999, amendment removed intent language and inserted the provision relating to small business stock discussed in this analysis.

### EFFECTIVE DATE

As a tax levy, this bill would be effective upon enactment and operative for taxable years beginning on or after January 1, 1999.

### LEGISLATIVE HISTORY

SB 671 (Ch. 881, Stats. 1993) enacted this capital gain exclusion; SB 1805 (Ch. 1243, Stats. 1994) codified act language from SEC. 28 of Senate Bill 671 (Stats. 1993, Chapter 881), relating to application of federal regulations to California's "stand alone" provision for a 50% exclusion of capital gains from the sale or exchange of qualified small business stock; SB 715 (Ch. 952, Stats. 1996) adopted the federal definition of "domestic corporation" (a corporation created or organized in the U.S. or any state) and also made technical, nonsubstantive changes that merely eliminated superfluous language; and SB 30 (current session) contains an identical provision to remove the January 1, 1999, sunset date.

#### Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
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<input checked="" type="checkbox"/> N	<input type="checkbox"/> OUA	<input type="checkbox"/> PENDING

#### Department Director

#### Date

**Gerald Goldberg**

**7/19/1999**

### SPECIFIC FINDINGS

Under both federal and California law, noncorporate investors may exclude 50% of the gain realized and recognized on the sale or exchange of qualified small business stock which has been held for more than five years. The amount that a taxpayer may exclude as gain with respect to qualified small business stock issued by the same issuer is limited to \$10 million (\$5 million for married individuals filing separate returns) or 10 times the taxpayer's original basis in the stock of the issuing corporation.

To qualify as small business stock for federal purposes, the stock must be that of a "C" corporation whose total gross assets (treating all members of the same parent-subsidiary controlled group as one corporation) at all times after August 10, 1993, and before the date of issuance, as well as immediately after the date of issuance, do not exceed \$50 million. The corporation also must meet certain reporting requirements. In addition, during substantially all of the taxpayer's holding period for the stock, the corporation issuing the stock (other than certain excluded corporations) must meet an active business test. Also, the taxpayer claiming the exclusion must have acquired the stock at its original issuance for money or other property (not including stock) or as compensation for services provided to the corporation.

In order to qualify as California qualified small business stock, however, the issuer must meet the following additional rules:

1. Have issued the stock before January 1, 1999;
2. Be doing business in California at all times on or after July 1, 1993;
3. Before the issuance of the stock, must have assets of \$50 million or less when measured as a controlled group using modified federal rules; and
4. Must have at least 80% of the total dollar value of its payroll attributable to employment located in California.

For both federal and California purposes, one-half of the amount of gain excluded is treated as a preference item under the alternative minimum tax (AMT).

**This bill** would remove the California law sunset date of January 1, 1999, on the issuance of qualified small business stock, thereby making the exclusion permanent.

One-half of the amount of gain excluded under this provision would continue to be treated as a preference item under the alternative minimum tax (AMT).

### Implementation Considerations

Implementing this proposal would not significantly affect the department's programs and operations.

Fiscal Impact on State Budget

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Revenue Impact of SB 30 Amended January 27, 1999 \$ Millions		
2003-4	2004-5	2005-6
\$(3)	\$(37)	\$(44)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The revenue impact of this measure depends on the amount invested in qualified stock, the rate of growth of market value of qualified stock, and the amount of gain realized during the relevant time periods.

The amount invested in qualified stock was estimated from data provided by the Western Association of Venture Capitalists (WAVC) and from academic research (Poterba, National Tax Journal, Vol XLII). The original analysis of the small business stock exclusion (1993) was based on investment data for the period 1991, a recession year. It was assumed that the long-term trend that was exhibited prior to 1988 would resume by 1996. Recent investment data provided by WAVC show that is the case.

It was assumed that half of the qualified firms would survive the first five years. Surviving companies' stock values were approximated using an annual growth rate of 40%. The historical pattern of professional venture capital holding periods was adjusted to take into account behavioral implications of the proposed extension of the exclusion.

The pattern of revenue losses shown in the table reflects the incremental impact of eliminating the current law sunset date. The current law exclusion is expected to result in increasingly larger revenue losses, approaching almost \$50 million by fiscal year 2002-3, and then current law losses are expected to drop to \$17 million in 2004-5 and continue declining thereafter because of the current sunset date. This bill would result in a resumption of the increasingly larger loss pattern exhibited prior to the sunset date.

For example, the current law exclusion is expected to result in revenue losses of \$17 million for fiscal year 2004-5. If this bill becomes law, the total losses would approach \$54 million for the first full year impact (fiscal year 2004-5) for an incremental revenue loss of \$37 million as shown in the table. Only a partial year impact of a net additional loss of \$3 million is shown for fiscal year 2003-4.

BOARD POSITION

At its March 23, 1999, meeting, the Franchise Tax Board voted 2-0 to take a neutral position on the February 19, 1999, version of SB 30, which contained an identical provision.